Dementia poses threat to aging boomers' portfolios

Fiduciaries may have their hands full, says upcoming research paper

By Jeff Nash
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A startling number of older adults either lack the cognitive abilities to manage their finances or delegate that responsibility to others — a finding that could have implications for plan executives and other fiduciaries as a wave of wealthy Americans approach retirement.

In a soon-to-be published re-search paper, “The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation,” David Laibson, a professor at Harvard University and noted expert in behavioral economics, found that the prevalence of dementia among Americans “explodes” after 60, doubling every five years to more than 30% of the population over 85.

Worse yet, many adults without dementia still experience “substantial cognitive impairment,” making it difficult for them to manage their portfolios.

Analytic cognitive function, according to the research, falls by about one percentile a year after 20.

As a result, nearly half the population between 80 and 89 is impaired by dementia or have cognitive impairment.

The paper was co-written by Sumit Agarwal, a senior financial economist at the Federal Reserve Bank of Chicago; John C. Driscoll, an economist at the Federal Reserve, and Xavier Gabaix, an associate professor of finance at the Leonard N. Stern School of Business at New York University.

“This is a huge problem, and we’re really doing nothing to prepare for the large number of wealthy Americans nearing retirement,” Mr. Laibson said in an interview. “In fact, we’ve really gone the opposite way by encouraging and liberating people to take care of their own finances.”

The new research comes as the White House and members of Congress look into possible retirement reforms — from increased fee disclosure to capping equity allocations in life cycle funds nearing their target dates — as many retirees suffered huge losses in savings during last year’s downturn.

The Government Accountability Office recently concluded that if no action is taken to “make the U.S. private-pension system more effective in protecting workers from risks to accumulating and preserving adequate savings for the retirement ... a considerable number of Americans face the prospect of a reduced standard of living.”

There is certainly a lot of wealth at stake.
According to the paper, for households headed by an individual 65-74, the median net worth — including net home equity and excluding public and private defined benefit assets — was $239,400 in 2007.

That figure is likely to grow much more quickly in the next three decades as more households go through a full lifetime of accumulating wealth in defined contribution plans, the authors said.

**TAKE THE LEAD**

Mr. Laibson argued that Washington will likely have to take the lead in tackling the issue of cognitive impairment among older adults.

“Plan sponsor executives are thinking about this, asset managers are thinking about this, but nobody knows the solution,” he said.

“We need a little bit of a regulatory nudge, because executives are afraid to try something new for fear of lawsuits,” Mr. Laibson said. “We have to start testing some possible solutions.”

By not taking action, the researchers argued, retirees lack protection from higher fees and poor investment decisions, and face the possibility of burning through their savings too quickly.

The paper identified nine possible policy options ranging from least to most paternalistic.

For example, improved disclosure is considered less paternalistic, though the authors doubt that such actions will effectively improve financial choices.

“Even for cognitively healthy populations, there is scant evidence that increases in disclosure improve decision making,” according to the paper.

The authors cited a study in which employees with low savings rates were given $50 each to read a short survey explaining their 401(k) plan and the benefits of the company match.

They didn't, however, change their savings rate relative to a control group.

A more paternalistic option, the report said, is “gentle nudges” from plan executives to steer older participants into the proper investments.

But while the authors said that they aren't opposed to the nudges, they said that older adults with “significant cognitive impairment may be no match for highly incentivized parties with malevolent interests and ample opportunities to nudge in the wrong direction.”

Other policy options in the paper: a laissez faire approach; requiring participants to pass a “licensing” test if they want to opt out of a safe-harbor investment or make other significant investment decisions; requiring older adults to develop a financial “advanced directive,” such as appointing a standard fiduciary, before reaching 70; regulating financial products with safety and quality standards; and requiring “explicit regulatory approval” of financial products.

Mr. Laibson, who stressed that his opinion doesn't necessarily jibe with his co-authors’, said that he leans toward requiring a portion of a retiree's assets to be protected in a safe-harbor investment such as an annuity.

For example, if an individual had three different retirement accounts, each account would automatically distribute 50% of its balance into the safe-harbor account.

Mr. Laibson added that an independent agency might be needed to monitor such a system to avoid abuses.

**SURPRISING SEVERITY**
Rod Bare, director of asset allocation strategies at Morningstar Inc., said that he is surprised by the "severity" of the rate of cognitive decline.

“There are a number of reasons why adults can't make their own financial decisions, and this highlights another one," he said. "Any solutions and discussions that come out of this [research] will be really beneficial to all of us.”

According to the paper, the degeneration of a person's cognitive function can result in poor financial decision making.

For example, research showed that middle-aged adults borrow at lower interest rates and pay fewer fees relative to younger and older adults.

Averaging across 10 credit markets, fee and interest-rate payments are at their lowest at around age 53.

Younger borrowers have high analytic function but little experience, while older borrowers have lots of experience and lower levels of analytic function, the report noted.

The authors focused on older adults because they “control more financial resources” and “cannot bounce back from their mistakes since cognitive and physical impairments frequently make it difficult to return to work.”

Mr. Bare agrees with Mr. Laibson that mandatory annuitization could go a long way toward solving the problem.

“The vast majority of data say 30% to 40% of an individual's portfolio should be put in a reasonably priced fixed-income annuity,” Mr. Bare said, adding that the United States could study the mandatory-annuitization system in the United Kingdom. "The issue is to make sure the financial-services industry does not come up with solutions that are too costly.”

Other experts worry that such an approach is too paternalistic.

David L. Wray, president of the Profit Sharing/401(k) Council of America, said that his organization is opposed to any mandates on DC plans.

"401(k) plans are where participants accumulate their own money," he said. "If the government intervenes and tells people how to use their savings, people will stop participating.”

Thomas Harty, a senior consultant at Portfolio Evaluations Inc., also disagrees that mandating a safe harbor is the best option.

“The market innovates and finds solutions to help people get prepared for retirement," he said.

“Mandating is scary. Now you have the government telling providers what to do, and it’s not clear annuities or any other single investment option is the best way to go for everyone,” Mr. Harty said.

He added that though the new research highlights the inability of older adults to make financial decisions, he has found that adults of all ages have difficulties managing their retirement portfolios.

“People don't know what to do with their money in general,” Mr. Harty said. “It may get worse the older you get, but really, this is a problem for all workers.”

Jeff Nash is a reporter for sister publication Pensions & Investments.
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